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Saturday, October 31, 2009

Incentives

Moral hazard and risk compensation for hikers.

> If they had not been toting the device that works like Onstar for hikers, "we would have never attempted this hike," one of them said after the third rescue crew forced them to board their chopper.

I hope everybody by now knows about the moral hazard and risk compensation that comes with securitization, and the central role of novel mortgage securitization in the recent financial crisis that led to the current recession. If not, here's a good example:

> By buying his mortgages and thus freeing up his capital to solicit even more business, Fannie and Freddie are a big reason Mr. Mozilo has driven [now-defunct sub-prime lender] Countrywide past the Citigroups and the Wells Fargos to the top of the mortgage heap. "If it wasn't for them," he said of Fannie and Freddie, "Wells knows they'd have us."

Here's my analysis of incentives and clocks:

> Mechanical clocks, bell towers, and sandglasses provided the world's first fair and fungible measure of sacrifice. So many of the things we sacrifice for are not fungible, but we can arrange our affairs around the measurement of the sacrifice rather than its results. Merchants and workers alike used the new precision of clock time to prove, brag, and complain about their sacrifices.

If you want something in an emergency you can wait in line, pay through the nose, or do without: choose one. Similar lessons apply to the current health care debate:

> In emergencies rationing becomes extreme: people wait in long lines, pay "extortionate" prices, or, even worse, do without. We are thrown into economically unfamiliar territory and transaction costs balloon. Goods will always be rationed in one or more of the above four ways, and in an emergency the rationing can be quite severe. Our charitable spirit can temporarily overcome self-interest, but it can't overcome the knowledge problem or the scarcity of goods.

Even in emergencies, when charity is most likely to spring forth, we need incentives. For example, doctors in emergencies are an interesting exception to the general rule in contract law against officious intermeddlers: if you are a patient who is in no position to consent or decline treatment, a doctor can go ahead and treat you and bill you. An implied-in-law or "quasi" contract has been formed. The same is not true in almost any other case: if that annoying windshield-washing guy starts cleaning your window without your consent, or if the neighbor kid comes along one day and mows your law without permission, you don't legally owe them a thing.

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Nick Szabo

"A premier thinker about history, law and economics, and the lessons they have for security." -- Adam Shostack, Emergent Chaos

"Szabo comes out with these essays that leave me in awe." -- Brian Dunbar

"Reading material that is eclectic, challenging and endlessly fascinating." -- Sean McGrath, Propylon

"Like most blogs worth my attention, this blog is updated only infrequently. That is because the authors of blogs worth my attention only post when they have something to say that is true, relevant and not already known by their audience. Most of the human race does not have the skill to know when an idea has these three properties. The skill is particularly rare in the fields of politics and economics, which is why this blog is such a rare and valuable thing." -- Richard Hollerith

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Posted by Nick Szabo at 1:25 PM

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